The Chapter XI Stay Order and the Secured Creditor

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During the past few years financially troubled debtors have made increasing use of chapter XI of the Bankruptcy Act.[1] The purpose of a chapter XI case is to permit a debtor to propose and secure a plan of arrangement with his unsecured creditors for the settlement, satisfaction, or extension of his unsecured debts. Although the chapter XI plan of arrangement cannot deal with the rights of secured creditors,[2] a chapter XI case usually has a significant impact upon secured creditors.

Section 311 of the Bankruptcy Act[3] grants exclusive jurisdiction to the chapter XI court over the debtor and all the debtor's property wherever located. As an adjunct to this broad grant of jurisdiction, section 314 grants the chapter XI court the power to enjoin or stay during the chapter XI case "the commencement or continuation of any proceeding to enforce any lien upon the property of a debtor." The full text of section 314 is as follows:

> The Court may, in addition to the relief provided by section 11 of this Act and elsewhere under this chapter, enjoin or stay until final decree the commencement or continuation of suits other than suits to enforce liens upon the property of a debtor, *and may, upon notice and for cause shown, enjoin or stay until final decree any act or the commencement or continuation of any proceeding to enforce any lien upon the property of a debtor.*[4]

Section 314 thus establishes different criteria for enjoining "lien" and "non-lien" proceedings. Although the court's injunctive power is discretionary in both instances, section 314 permits the exercise of such power in a "lien" proceeding only "upon notice and for cause shown." Therefore, under section 314 three essential steps are necessary before the court will enjoin or stay a lien proceeding: (1) the debtor must move the court for a stay or an injunction against the commencement or continuation of the action; (2) the court must give notice of this

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1. The provisions of the Bankruptcy Act governing chapter XI cases are contained in sections 301 through 399 of that Act. 11 U.S.C. §§ 701-99 (1970).

2. Section 306(1) of the Bankruptcy Act defines an "arrangement" to be "any plan of a debtor for the settlement, satisfaction, or extension of the time of payment of his *unsecured debts*, upon any terms." 11 U.S.C. § 706(1) (1970) (emphasis added). Section 356 of chapter XI provides that any chapter XI plan must "include provisions modifying or altering the rights of unsecured creditors generally or of some class of them." 11 U.S.C. § 756 (1970).

3. 11 U.S.C. § 711 (1970). All future references to "sections" refer to sections of the Bankruptcy Act unless otherwise stated.

4. 11 U.S.C. § 714 (1970) (emphasis added).

motion to the secured creditor; and (3) the debtor must show cause why the stay should be granted.

On July 1, 1974, rule 11-44 of the Bankruptcy Rules[5] took effect, making automatic the discretionary stay provisions of section 314. Rule 11-44(a) provides that the filing of a chapter XI petition

> shall operate as a stay of the commencement or the continuation of any court or other proceeding against the debtor, or the enforcement of any judgment against him, or of any act or the commencement or continuation of any court proceeding to enforce any lien against his property, or of any court proceeding, except a case pending under Chapter X of the Act, for the purpose of the rehabilitation of the debtor or the liquidation of his estate.

As a result of rule 11-44(a), the filing of a chapter XI petition automatically stays the commencement or continuation of any proceeding or act by a secured creditor to enforce his lien. This article will analyze the impact of such a stay.[6]

I. RULE 11-44 AND MORTGAGE FORECLOSURE PROCEEDINGS

A. *The Problem*

Probably the greatest impact of rule 11-44 is upon mortgage lenders of the debtor who desire to foreclose their mortgages. Almost all chapter XI debtors have at least one real property asset encumbered by a mortgage, and many debtors have several. This is particularly true of real estate development companies, which are utilizing chapter XI proceedings with increasing frequency. The debtor who files a chapter XI case is typically in default on his mortgage payments and is often already a defendant in a foreclosure proceeding. If the mortgagee has not filed a foreclosure proceeding prior to the chapter XI filing, this filing will often convince the mortgagee that a foreclosure is necessary, especially if the chapter XI debtor-in-possession retains the rents and profits from the mortgaged premises without making the mortgage payments.

The rule 11-44 stay order stays both the commencement and the continuation of a foreclosure proceeding. Therefore, in the absence of possession by a mortgagee or a receiver[7] the impact of a chapter XI filing upon a mortgagee who has not filed a foreclosure is the same as upon a mortgagee who has—neither one can proceed further with the commencement or continuation of the foreclosure proceeding.[8]

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5. All future references to "rules" refer to Bankruptcy Rules, 11 U.S.C. app. (Supp. V 1975), unless otherwise stated.

6. Although this article will analyze the effect of a rule 11-44 stay on a secured creditor, some of the discussion will be equally relevant to chapter X, XII, and XIII proceedings, which contain rules almost identical to rule 11-44 in rules 10-601, 12-43, and 13-401 respectively.

7. *See* the discussion relating to a mortgagee in possession, section II *infra*.

8. In a straight bankruptcy proceeding it does make a difference whether a mortgagee

Since rule 11-44 enjoins any act as well as any proceeding to enforce a lien, it prevents the mortgagee from exercising other rights it may have pursuant to its loan documents, such as attempting to enforce its assignment of rents, or repossessing any personal property the mortgagee has as additional collateral.

The rule 11-44 stay continues until the case is closed, dismissed, or converted to a straight bankruptcy case unless the court terminates or modifies it;[9] thus the ability to act quickly and correctly to secure relief from the stay upon the filing of a chapter XI case is critical to the position of the mortgagee.[10]

B. *Procedures Established by Rule 11-44*

In order to secure relief from the rule 11-44 stay the mortgagee must file an adversary proceeding pursuant to part VII of the Bankruptcy Rules.[11] This proceeding is commenced by filing a complaint with the chapter XI court.[12] The court then sets a trial date and issues a summons and notice of trial.[13] After service of the summons, complaint, and notice of trial,[14] the debtor has twenty-five days to file its answer, unless a different time is prescribed by the court.[15]

Rule 11-44(d) establishes the mechanics of relief from stay:

> Upon the filing of a complaint seeking relief from a stay provided by this rule, the bankruptcy court shall, subject to the provisions of sub-

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has commenced a foreclosure prior to the filing of a bankruptcy petition. Rule 601(a), the straight bankruptcy provision regarding stays against lien enforcement, provides that the filing of a bankruptcy petition shall operate as a stay of any court proceeding to "enforce a lien against property in the custody of the bankruptcy court." The phrase "custody of the bankruptcy court" is crucial to the position of a mortgagee who has already commenced a foreclosure proceeding before bankruptcy. The Advisory Committee's note to rule 601(a) provides:

> Subject to the possible limitation imposed by the second clause of subdivision (a) [relating to liens obtained within four months of bankruptcy], the stay provided by this rule does not operate to prevent the continuation of any proceeding or act to enforce a lien when the creditor has possession at the time of bankruptcy. Thus, a pledgee may enforce his lien after bankruptcy, see 1 Collier ¶ 2.62[3] (1968); and a mortgagee who has commenced foreclosure proceedings in a state or federal district court before bankruptcy may continue them notwithstanding the stay, see *id.* ¶ 2.63[1].

9. Rule 11-44(b) provides:

> *Duration of Stay.* Except as it may be deemed annulled under subdivision (c) of this rule or may be terminated, annulled, modified, or conditioned by the bankruptcy court under subdivision (d), (e), or (f) of this rule, the stay shall continue until the case is closed, dismissed, or converted to bankruptcy or the property subject to the lien is, with the approval of the court, abandoned or transferred.

10. The filing of a chapter XI case does not affect suits against the officers and directors of the debtor, Teledyne Industries v. Eon Corp., 401 F. Supp. 729 (S.D.N.Y. 1975), or against a subsidiary of the chapter XI debtor. Knickerbocker Fed. Sav. & Loan Ass'n. v. Fashion Wear Realty Co. (*In re* Fashion Wear Realty Co.), 1 BANKR. CT. DEC. (CRR) 1365 (S.D.N.Y. 1975).

11. Rules 701 through 782 of the Bankruptcy Rules, which include by reference several of the Federal Rules of Civil Procedure.

12. Rule 703.

13. Rule 704(a).

14. Rule 704 contains the service of process provisions.

15. Rule 712(a).

> division (e) of this rule, set the trial for the earliest possible date, and it shall take precedence over all matters except older matters of the same character. The court may, for cause shown, terminate, annul, modify or condition such stay. A party seeking continuation of a stay against lien enforcement shall show that he is entitled thereto.

The complaint should set forth the reasons why the stay should be modified or vacated. Since an answer will be filed and admissions are possible, the complaint should contain detailed allegations concerning the note and mortgage, the existence of default, the unpaid balance of debt, and other liens on the property. Furthermore, although rule 11-44(d) places the burden of proof on the debtor in an 11-44 adversary proceeding, the creditor must make a prima facie case, so the complaint should not be too general. A good rule of thumb is to include the same detail in a complaint to vacate a stay as in a typical foreclosure complaint.

Since rule 11-44(d) provides that proceedings to secure relief from a stay take precedence over all other matters, except older 11-44 proceedings, the attorney for a mortgagee should be able to secure an early trial date.[16] However, the provision that the debtor has twenty-five days to answer could cause a delay unless the court orders a shorter period. Since rule 712(a) expressly permits the court to prescribe a different time, the mortgagee's attorney should always attempt to get an earlier answer day in order to obtain the earliest trial date possible.

The trial on a complaint seeking relief from stay proceeds in the same manner as any other trial in bankruptcy court, and the Federal Rules of Evidence apply.[17] Pretrial discovery procedures similar to those of the Federal Rules of Civil Procedure are also available.[18]

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16. Rule 11-44(e) provides limited authority for ex parte relief from stay. However, one of the requirements for ex parte relief is a clear showing that "immediate and irreparable injury, loss, or damage" will result before the adverse party can be heard, which is rarely the case in a mortgage foreclosure situation. Rule 11-44(e) provides:

> *Ex Parte Relief from Stay.* Upon the filing of a complaint seeking relief from a stay against any act or proceeding to enforce a lien or any proceeding commenced for the purpose of rehabilitation of the debtor or the liquidation of his estate, relief may be granted without written or oral notice to the adverse party if (1) it clearly appears from specific facts shown by affidavit or by a verified complaint that immediate and irreparable injury, loss, or damage will result to the plaintiff before the adverse party or his attorney can be heard in opposition, and (2) the plaintiff's attorney certifies to the court in writing the efforts, if any, which have been made to give the notice and the reasons supporting his claim that notice should not be required. The party obtaining relief under this subdivision shall give written or oral notice thereof as soon as possible to the trustee, receiver, or debtor in possession and to the debtor and, in any event, shall forthwith mail to such person or persons a copy of the order granting relief. On 2 days' notice to the party who obtained relief from a stay provided by this rule without notice or on such shorter notice to that party as the court may prescribe, the adverse party may appear and move its reinstatement, and in that event the court shall proceed to hear and determine such motion as expeditiously as the ends of justice require.

17. Rule 917.

18. Rules 726 through 737.

As previously noted, Rule 11-44 shifts the burden of bringing the stay order issue to the court from the debtor to the creditor and at trial the creditor must make an initial showing of facts that would entitle him to relief from the stay.[19] However, the last sentence of rule 11-44(d) clearly establishes that the debtor has the overall burden to show that he is entitled to a continuation of the 11-44 stay.[20]

C. *Judicial Standards Applied to a Showing of Cause*

Rule 11-44(d) provides that "for cause shown" the chapter XI court may terminate, annul, modify, or condition the rule 11-44 stay. The central issue in a trial seeking relief from a stay is, therefore, identical to that in section 314, and its predecessor, section 77B(c)(10) of the Bankruptcy Act[21]—what constitutes "cause shown" for purposes of obtaining (under section 314), terminating, modifying, or continuing the stay. The courts have established numerous and sometimes conflicting guidelines over the years in interpreting section 77B(c)(10), section 314, and rule 11-44.

One of the better reasoned decisions establishing appropriate guidelines was one of the first decided under rule 11-44. *National Life Insurance Co. v. Jenifer Mall Corp.*[22] involved a complaint filed by a mortgagee to vacate an 11-44 stay to enable the mortgagee to continue with a foreclosure proceeding.[23] The mortgagee held a mortgage on a shopping center which was virtually the debtor's only asset. The court held that there were four relevant guidelines in determining whether a stay order should be vacated:

1. the extent of the debtor's equity in the property in issue;
2. the potential of substantial injury to the secured creditor;
3. the demonstrated need for a stay in reference to the objectives of the debtor, vis-a-vis his unsecured creditors; and

19. In a nonmortgage foreclosure case the Southern District Court of New York has held that the creditor has the initial burden to "show cause why continuance of the stay would cause irreparable damage." First Nat'l Bank v. Overmyer Co. (*In re* Overmyer Co.), 2 BANKR. CT. DEC. (CRR) 992, 993 (S.D.N.Y. 1976). However, "upon such showing, and under the unambiguous language of the last sentence of Rule 11-44(d), the burden shifts to the debtor to demonstrate its entitlement to continuation of the stay." *Id.*

20. Chemical Bank v. American Kitchen Foods, Inc. (*In re* American Kitchen Foods, Inc.), 2 BANKR. CT. DEC. (CRR) 715 (D. Me. 1976); Otay Land Co. v. DLB Dev. Corp. (*In re* DLB Dev. Corp.), 1 BANKR. CT. DEC. (CRR) 1463 (S.D. Cal. 1975); *In re* Alex Reynolds, 1 BANKR. CT. DEC. (CRR) 210 (D. Ga. 1974); National Life Ins. Co. v. Jenifer Mall Corp. (*In re* Jenifer Mall Corp.), 1 BANKR. CT. DEC. (CRR) 179 (D.D.C. 1974). *See also* 8 COLLIER ON BANKRUPTCY ¶ 3.20, at 240 (14th ed. 1976).

21. Section 77 B(c)(10) provided in part that the court had power to:
enjoin or stay the commencement or continuation of suits against the debtor until after final decree; and may, upon notice and for cause shown, enjoin or stay the commencement or continuance of any judicial proceeding to enforce any lien upon the estate until after final decree. 48 Stat. 912 (1934).

22. 1 BANKR. CT. DEC. (CRR) 179 (D.D.C. 1974).

23. Apparently a nonjudicial foreclosure was involved, since a sale was scheduled pursuant to a notice of foreclosure sale filed in the office of the recorder of deeds.

4. whether or not a suitable arrangement can be effected without altering the rights of the secured creditors.[24]

Applying these guidelines to the facts before it, the court concluded that the stay order should be vacated. It found that the debtor had little, if any, equity in the property over the claims of secured creditors. The demonstrated equity over the amount of the first mortgage of the plaintiff would be reduced to zero in approximately five months as a result of accruing interest. The court was concerned that the debtor's continued economic existence depended upon possession of the shopping center; however, the rental income of this sole asset was insufficient to pay even the monthly payments to the plaintiff, let alone to provide funds for a plan of arrangement with unsecured creditors. In vacating the stay, the court determined that success of a plan of arrangement with unsecured creditors depended upon improved future business conditions and that there was no justification for delaying a secured creditor in the hope that the economy would improve.

The *Jenifer Mall* court also recognized that a chapter XI plan of arrangement can affect only the rights of unsecured creditors, and that a clear showing must be made to continue a stay against a secured creditor. It has been noted that stronger grounds must be shown for continuation of a rule 11-44 stay than a stay arising under former section 77B or under chapter X of the Bankruptcy Act, since those cases can deal with the rights of secured parties.[25] This factor has appeared in decisions both before and after the enactment of rule 11-44. The Tenth Circuit recognized this in a section 314 decision:

> Since, however, only the rights of unsecured creditors of the debtor may be arranged, . . . the court should not exercise its injunctive powers in a manner to alter the rights of the secured creditors of the debtor . . . . If adequate relief cannot be granted without affecting the rights of secured creditors, the Bankruptcy Act has provided an adequate remedy in Chapter X and elsewhere in the Act.[26]

The Ninth Circuit reached the same conclusion in another section 314 decision:

> One who by his foresight and prudence is a secured creditor, who has a lien upon property rather than the mere general obligation of a debtor, deserves, and has, a better legal status than that to which Lance [the chapter XI debtor] would have us relegate Dewco [the mortgagee] in this case.[27]

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24. 1 BANKR. CT. DEC. (CRR) at 181.

25. 8 COLLIER ON BANKRUPTCY ¶ 3.22, at 256 (14th ed. 1976). A chapter XII real property arrangement also can affect secured creditors and would be in the same category as a chapter X.

26. Chaffee County Fluospar Corp. v. Athan, 169 F.2d 448, 450 (10th Cir. 1948).

27. Lance, Inc. v. Dewco Servs., Inc., 422 F.2d 778, 781 (9th Cir. 1970).

These pre-rule 11-44 rulings emphasizing the need to place the burden on the debtor because of the very nature of a chapter XI case[28] are sound, and the procedural change accomplished by rule 11-44 should not make it easier for the debtor to continue the stay than it was previously. The function of a chapter XI case is to secure a plan of arrangement with unsecured creditors, and unless the courts place a substantial burden on the debtor to show cause why the stay should be continued, these cases will exceed the scope intended for them by Congress.[29] Fortunately, the *Jenifer Mall* case recognized this, and did not change the substantive law concerning the factors that must be established to continue a stay against secured creditors.

Of the factors set forth in *Jenifer Mall*, probably the most important one is the extent of the debtor's equity in the mortgaged premises. The decisions are almost uniform in holding that if the debtor has no equity in the mortgaged premises, the debtor cannot establish cause for continuing the stay because the premises would not produce any proceeds for the debtor or the unsecured creditors.[30] In the one ruling that continued the stay in the absence of a showing of equity the bankruptcy judge allowed the mortgagee to continue with its state court foreclosure action so long as it took no final action therein to secure possession of the mortgaged premises.[31]

A more difficult issue for the courts has been whether the existence of debtor's equity is enough to justify continuance of the stay regardless of other factors. The obvious argument for continuing the stay when there is equity is that the equity can be preserved for the benefit of the debtor and his unsecured creditors. However, this must be weighed against the harm to the secured creditor. As *Jenifer Mall* indicates, not every case in which there is equity is a proper one for

28. *See also In re* Empire Steel Co., 228 F. Supp. 316 (D. Utah 1964); *In re* Tracy, 194 F. Supp. 293, 296 (N.D. Cal. 1961) ("If there is to be an arrangement for the primary purpose of altering the rights of creditors holding debts secured by real property, it must be under the provision of Chapter XII of the Bankruptcy Act . . . .").

29. Even in a proceeding under former section 77(B), which did permit the plan to affect secured creditors, the debtor had to make a clear showing that the stay against secured creditors was necessary. In Metropolitan Life Ins. Co. v. Murel Holding Corp. (*In re* Murel Holding Corp.), 75 F.2d 941, 942 (2d Cir. 1935), Judge Learned Hand observed that "the stay so authorized [by section 77B(c)(10)], like any other, lies in the court's discretion; prima facie the creditor may go on to collect; if his hand is to be held up, the debtor must make a clear showing."

30. Lance, Inc. v. Dewco Servs., Inc., 422 F.2d 778 (9th Cir. 1970) (section 314 case); Silver Gate Sav. and Loan Ass'n v. Carlson (*In re* Victor Builders), 418 F.2d 880 (9th Cir. 1969) (section 314 case); Metropolitan Life Ins. Co. v. Murel Holding Co. (*In re* Murel Holding Corp.), 75 F.2d 941 (2d Cir. 1935) (section 77(B) case); *In re* Red Carpet Corp., BANK. L. REP. (CCH) ¶ 66206 (N.D. Fla. 1976) (rule 11-44 case); Otay Land Co. v. DLB Dev. Corp. (*In re* DLB Dev. Corp.), 1 BANKR. CT. DEC. (CRR) 1463 (S.D. Cal. 1975) (rule 11-44 case); National Life Ins. Co. v. Jenifer Mall Corp. (*In re* Jenifer Mall), 1 BANKR. CT. DEC. (CRR) 179 (D.D.C. 1974) (rule 11-44 case).

31. Metropolitan Sav. Ass'n v. Johnson (*In re* Royal Scot, Ltd.), 2 BANKR. CT. DEC. (CRR) 374 (W.D. Mich. 1976).

continuation of the stay order. Most of the decisions that have used equity as a ground for continuing the stay have combined it with other grounds,[32] although some state that a showing of equity by the debtor is a complete defense to a rule 11-44 proceeding.[33] The better rule appears to be that equity alone is not enough to continue the stay if other factors outweigh it.

In *In re Empire Steel Co.*[34] the court considered a motion to vacate a section 314 stay that had been granted ex parte. The Small Business Administration attempted to vacate the section 314 stay in order to foreclose its mortgage and the debtor attempted to limit the evidence on whether the stay should be vacated to the existence of equity in the property. In rejecting the contention that the existence of equity was the only relevant issue, the district court held that the "adequacy or inadequacy of the government's security was only one of the questions upon which a decision should have been predicated."[35] Noting that the case had been pending for one year with no plan having been filed and that mere speculation concerning a plan should not be enough to indefinitely stay secured creditors, the district court remanded the proceeding to the bankruptcy referee for the purpose of taking more evidence on criteria other than the debtor's equity.

Since the equity factor in a rule 11-44 proceeding is so important, the attorney for the mortgagee should be prepared to offer expert testimony concerning the amount of the secured indebtedness and the value of the mortgaged premises. Also important, yet often overlooked,[36] is the existence of other liens, including real estate tax liens, against the mortgaged premises, since such liens reduce the debtor's

32. *In re* Atchafalaya Workover Contractors, Inc., 1 BANKR. CT. DEC. (CRR) 499 (W.D. La. 1975) (rule 11-44 case; rehabilitation likely to be successful; monthly payments to be made to secured creditor; causes of chapter XI were nonrecurring hazard losses); *In re* Metro Meat Packing, 1 BANKR. CT. DEC. (CRR) 229 (D. Minn. 1974) (section 314 case; vacating stay would defeat the arrangement, no harm to secured creditor; economy of community would be benefited); *In re* Alex Reynolds, 1 BANKR. CT. DEC. (CRR) 210 (D. Ga. 1974) (rule 11-44 case; substantial harm to estate; adequate protection prescribed for mortgagee); *In re* Tracy, 194 F. Supp. 293 (N.D. Cal. 1961) (section 314 case; sale by mortgagee would disrupt proceeding; no harm to secured creditor); *In re* Atlantic Steel Products, 31 F. Supp. 408 (E.D.N.Y. 1939) (section 314 case; very short stay; whole arrangement, which had already been accepted, would be defeated).

33. Sal Amato, Inc. v. First Wis. Nat'l Bank (*In re* Sal Amato, Inc.), 1 BANKR. CT. DEC. (CRR) 954, 955 (D. Conn. 1975) ("[I]f, as alleged, there is substantial equity, it would be a complete defense to the request that the court exercise its discretion in vacating the stay."). In remanding a section 314 case to the district court the Ninth Circuit stated, in Silver Gate Sav. and Loan Ass'n v. Carlson (*In re* Victor Builders, Inc.), 418 F.2d 880, 882 (9th Cir. 1969):

> If there is such an equity, the referee should permanently enjoin the foreclosure until final decree. If, on the other hand, there is no equity for the general creditors, the referee should discharge the temporary restraining order and permit the appellant to proceed with the non-judicial sale.

34. 228 F. Supp. 316 (D. Utah 1964).

35. *Id.* at 319.

36. This was recognized in National Life Ins. Co. v. Jenifer Mall Corp. (*In re* Jenifer Mall), 1 BANKR. CT. DEC. (CRR) 179 (D.D.C. 1974).

equity and the fund that would be available for the unsecured creditors. In establishing the value of the mortgaged premises the parties should use testimony of appraisers with respect to the "fair market value" of the premises. This has been defined by one court as "what an owner, willing but not compelled to sell, would take for his property and what a buyer, willing but not compelled to buy, would be willing to pay for said property."[37]

Closely akin to the presence or absence of equity in the mortgaged premises is the second *Jenifer Mall* guideline, *i.e.*, the potential of substantial injury to the mortgagee. Since a mortgagee has bargained for his secured position, it would be unconstitutional[38] and manifestly unjust to enjoin him from foreclosing the mortgage if the delay would cause him substantial injury. No court has held that the rule 11-44 stay should be continued if the result would be substantial injury to the secured creditor. Some have held that when there is significant equity, there will be no harm to the secured creditor since he will eventually recover his entire debt from the property.[39] On the other hand, if there is no equity the secured creditor will be substantially injured by continuance of the stay, since the longer he is denied the right to possession and sale of the mortgaged premises the greater his losses will be. Courts have refused to continue a stay when a mortgagee was suffering losses of one thousand dollars per day in interest and taxes,[40] when the debtor was unable to operate the property and the mortgagee was being required to advance large sums to keep the property viable,[41] when the debtor had not made any payments to the mortgagee,[42] and when the mortgagee would suffer liquidity problems if it could not realize upon the mortgaged premises.[43]

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37. Otay Land Co. v. DLB Dev. Corp. (*In re* DLB Dev. Corp.), 1 BANKR. CT. DEC. (CRR) 1463, 1467 (S.D. Cal. 1975). This case also contains a good discussion of what factors the court will consider in determining fair market value.

38. *See* Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW. 15 (1974).

39. *In re* Metro Meat Packing, 1 BANKR. CT. DEC. (CRR) 209 (D. Minn. 1974); *In re* Alex Reynolds, 1 BANKR. CT. DEC. (CRR) 210 (D. Ga. 1974); *In re* Tracy, 194 F. Supp. 293 (N.D. Cal. 1961); *In re* Atlantic Steel Products, 31 F. Supp. 408 (E.D.N.Y. 1939).

40. Otay Land Co. v. DLB Dev. Corp. (*In re* DLB Dev. Corp.), 1 BANKR. CT. DEC. (CRR) 1463 (S.D. Cal. 1975).

41. Lance, Inc. v. Dewco Servs., Inc., 422 F.2d 778 (9th Cir. 1970).

42. C.I. Mortgage Group v. Groundhog Mt. Corp. (*In re* Groundhog Mt. Corp.), 1 BANKR. CT. DEC. (CRR) 923 (S.D.N.Y. 1975).

43. First Fed. Sav. and Loan Ass'n v. Holiday Lodge, Inc. (*In re* Holiday Lodge, Inc.), 300 F.2d 516 (7th Cir. 1962). The Seventh Circuit found in this case that the chapter XI court does not have jurisdiction to stay foreclosure of property owned by a third party that is leased to the debtor by a lease subordinate to the mortgage. However, in noting that there were other reasons why a stay granted by the bankruptcy court should not be continued, the court suggested an interesting argument for a financial institution mortgagee:

> We are not unaware of the natural effect of prolonged interference with a foreclosure proceeding brought by a savings association, such as appellant in this case. It amounts to a freezing of assets, while it is in effect, a condition which is not consistent with that

As stated earlier, even if there is equity in the mortgaged premises, the continuation of the stay should not be granted if potential damage to the secured creditor outweighs the equity factor. For example, if the property is subject to rapid deterioration, the secured creditor must be allowed to move quickly to protect its security. This is especially true with respect to property that the debtor is unable to maintain. Financially troubled debtors are often unable to provide the funds necessary to maintain facilities or insure them. Without proper maintenance or insurance substantial deterioration to the property may occur, rendering any present equity illusory. Uncompleted projects are particularly subject to rapid deterioration. Although equity may exist when the project is completed, the debtor in chapter XI usually cannot afford to complete; if the project remains uncompleted for any period of time, significant losses may occur. The mortgagee should be able to cut its losses by obtaining possession of the mortgaged premises in order to complete them and avoid the often catastrophic losses associated with increasing building costs, escalating interest, and loss of prospective lessees.[44]

The third *Jenifer Mall* guideline—the demonstrated need for a stay in reference to the objectives of the debtor in securing a plan of arrangement with his unsecured creditors—has often been expressed in terms of whether the mortgaged premises are essential to a chapter XI plan. If the plan cannot succeed without use of the mortgaged premises, courts are reluctant to vacate the stay unless continuing it will substantially injure the mortgagee.[45] In *In re Tracy*,[46] the debtor owned both business premises and a residence. The second lienholder, who had a blanket lien on both properties to secure one debt, sought to sell the properties pursuant to its security agreement.[47] The debtor petitioned for a section 314 stay of the sale proceeding, and the bankruptcy referee granted the stay based upon his finding that there was a substantial equity in the properties and that consum-

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degree of liquidity requisite in any financial organization engaged in the acceptance of investment of the funds of many members of the public.

Id. at 520.

44. Lifton, *Real Estate in Trouble: Lendee's Remedies Need an Overhaul*, 31 BUS. LAW. 1927 (1976).

45. "To allow secured creditors to repossess their collateral at this time will eliminate any possibility of an arrangement. It is my opinion that the advantages of possibly saving the business for the benefit of unsecured creditors, employees, debtor, and even the community, far outweigh any possible damage to the secured parties by temporarily staying their rights to repossess." Metropolitan Sav. Ass'n v. Johnson (*In re* Royal Scot, Ltd.), 2 BANKR. CT. DEC. (CRR) 374, 377 (W.D. Mich. 1976). *See also In re* Metro Meat Packing, Inc., 1 BANKR. CT. DEC. (CRR) 229 (D. Minn. 1974); *In re* Alex Reynolds, 1 BANKR. CT. DEC. (CRR) 210 (S.D. Ga. 1974); *In re* Atlantic Steel Products Corp., 31 F. Supp. 408 (E.D.N.Y. 1939).

46. 194 F. Supp. 293 (N.D. Cal. 1961).

47. The second lienholder was actually secured by a deed of trust and was apparently attempting to sell as a result of a power of sale contained in the deed of trust.

mation of a foreclosure sale would endanger the success of the arrangement. The district court sustained the referee's holding with respect to the business property because the debtor had substantial equity and its sale might "disrupt the Chapter XI proceeding."[48] However, the district court, finding that the residence was separated from the business by fourteen miles of mountain road, was unable to see how a sale of the residence would interfere with the debtor's objectives in securing an arrangement with his unsecured creditors. Remanding with instructions to the referee to reconsider his order restraining the sale of the residence, the court stated:

> It is difficult for the Court to appreciate how a residence in Twain Harte can be of such essential necessity to the transaction of business in Jamestown as to justify the restraining order. *If the purpose of the order was to give Debtor time to sell the residence and pay both his secured and unsecured creditors, then it would seem to alter the relative rights and positions of secured and unsecured creditors, and in such case it would be outside of the proper scope of a chapter XI proceeding.*
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> The annoyance to Debtor of losing his residence is not, in and of itself, a sufficient disadvantage to the consummation of the arrangement as to warrant the restraining order. . . . On the basis of the record now before the Court, it would not appear to be legally objectionable to permit the sale of the residence under the deed of trust, even if the sale of the business property may have to be restrained to prevent disruption of the arrangement.[49]

In re Tracy clearly articulated the difference between property that was essential to the debtor's plan and property that was not essential. However, even when property is essential to the debtor's plan a stay should not be granted if there is little equity in the property and very little chance of a successful plan. Of critical importance to whether a court will grant a stay against property that is essential to a chapter XI plan is the court's assessment of the likelihood that the debtor can effectuate a suitable plan. If the prospects for a successful plan are good, the courts are likely to preserve any asset essential to the plan unless the secured creditor can show substantial injury.[50] On the other hand, if the only hope for the debtor's plan of arrangement is a speculative or contingent future development, such as a turnaround in the economy, the stay should not be continued even if the property is essential to the plan and there is equity.[51] This principle was articulated in *In re Empire Steel Co.* as follows:

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48. 194 F. Supp. at 296.

49. *Id.* (emphasis added).

50. Koury v. Dressmaker Fabrics (*In re* Dressmaker Fabrics), 2 BANKR. CT. DEC. (CRR) 304, 305 (S.D.N.Y. 1976); Sal Amato, Inc. v. First Wis. Nat'l Bank (*In re* Sal Amato), 1 BANKR. CT. DEC. (CRR) 954, 955 (D. Conn. 1975); *In re* Atchafalaya Workover Contractors, Inc., 1 BANKR. CT. DEC. (CRR) 499, 500 (W.D. La. 1975); *In re* Alex Reynolds, 1 BANKR. CT. DEC. (CRR) 210 (S.D. Ga. 1974).

51. First Fed. Sav. and Loan Ass'n v. Holiday Lodge, Inc. (*In re* Holiday Lodge, Inc.),

> It is emphasized that in Chapter XI proceedings 'only the rights of unsecured creditors of the debtor may be arranged and this without alteration of the status of any other classes of security holders.' *If there is no possibility of submitting a plan except upon the happening of some future contingency, the basis for any protracted stay simply does not exist. Otherwise, secured creditors could be indefinitely delayed, for almost every debtor hopes that something may happen in the future to relieve his plight and permit him to avoid foreclosure.* Chapter XI would become simply authority for general moratoria against secured creditors rather than a means to permit appropriate submission, processing and consideration of plans of adjustment. The 'status' of secured creditors then unavoidably would be affected, for status depends not only upon assurance of eventual payment but the right to payment or enforcement in point of time bearing some relationship to the conditions of the security instruments.
>
> . . . .
>
> The Referee's consideration of the propriety of the stay was too narrow. The adequacy or inadequacy of the government's security was only one of the questions upon which a decision should have been predicated.[52]

In addition to the factors set forth in *Jenifer Mall* as guidelines for continuing a stay, the courts have developed other relevant criteria which are usually associated with one or more of the *Jenifer Mall* guidelines. Closely related to the factors of harm to the secured creditor and the prospects for a successful plan is the length of time the stay has been in effect when the question is decided. If the stay has been in effect for some time and a plan has not yet been accepted, the courts are reluctant to permit the debtor to continue the stay.[53] Courts have refused to continue the stay when the proceeding had been pending for one year and no plan had been submitted,[54] when the debtor had had the benefit of the stay for ten months yet had no viable business,[55] and when the stay had been in existence for nine months and the debtor had not moved toward effecting the plan.[56] If the debtor is permitted to keep the stay order in effect for any lengthy time, he in effect forces his secured creditors to finance the chapter XI case.

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300 F.2d 516, 520 (7th Cir. 1962); Metropolitan Life Ins. Co. v. Murel Holding Corp. (*In re* Murel Holding Corp.), 75 F.2d 941, 942-43 (2d Cir. 1935); C.I. Mortgage Group v. Groundhog Mt. Corp. (*In re* Groundhog Mt. Corp.), 1 BANKR. CT. DEC. (CRR) 923, 925 (S.D.N.Y. 1975).

52. 228 F. Supp. 316, 319 (D. Utah 1964) (emphasis added).

53. "No doubt less will be required to hold up the suit for a short time until the debtor shall have a chance to prepare; much depends upon how long he has had already, and upon how much more he demands." Metropolitan Life Ins. Co. v. Murel Holding Corp. (*In re* Murel Holding Corp.), 75 F.2d, 941, 943 (2d Cir. 1935).

54. *In re* Empire Steel Co., 228 F. Supp. 316 (D. Utah 1964).

55. Otay Land Co. v. DLB Dev. Corp. (*In re* DLB Dev. Corp.), 1 BANKR. CT. DEC. (CRR) 1463 (S.D. Cal. 1975).

56. C.I. Mortgage Group v. Groundhog Mt. Corp. (*In re* Groundhog Mt. Corp.), 1 BANKR. CT. DEC. (CRR) 923 (S.D.N.Y. 1975).

A final factor courts consider in determining whether to continue the stay is whether the debtor is making payments to the mortgagee during the pendency of the chapter XI case. If the debtor is making payments, he is obviously in a better position to defend a rule 11-44 proceeding[57] than if he is not.[58] However, the failure to make mortgage payments standing alone has been held insufficient to justify vacating the stay.[59] The harshness of this rule is sometimes mitigated by the fact that mortgage payments that have not been paid during a chapter XI case may be administrative expenses entitled to priority in payment out of the chapter XI deposit.[60]

Thus, a number of factors must be considered in determining whether a rule 11-44 stay should be continued, and one factor is almost never controlling. Generally, a debtor must at least establish that he has equity in the property and that there will be no substantial injury to the mortgagee as a result of the stay. The debtor should also be required to establish that the property is essential to a successful plan of arrangement and that the prospects for success of the plan are good. Since Congress has provided that a chapter XI arrangement cannot alter or modify the rights of secured creditors, courts must be careful not to alter or modify these rights by an indefinite continuation of the rule 11-44 stay.

A careful examination of decisions that have granted a continuance of the stay reveal that the courts recognize the need to protect secured creditors in a chapter XI case, since most of the decisions impose protective conditions on a continuance. For instance, one court authorized the issuance of certificates of indebtedness to pay interest to the secured party during the continuance of the stay,[61] another court ordered monthly payments to be made to the secured creditor,[62] another ordered that a previously filed state court foreclosure could proceed as long as the mortgagee did not take possession,[63] another stated it would continue the 11-44 proceeding with a careful monitoring of subsequent developments and would grant

57. Koury v. Dressmaker Fabrics (*In re* Dressmaker Fabrics), 2 BANKR. CT. DEC. (CRR) 304 (S.D.N.Y. 1976) (lessee made payments from date of chapter XI filing). *Cf.* D.H. Overmyer Co. v. Herzog (*In re* D.H. Overmyer Co.), 510 F.2d 329 (2d Cir. 1975) (failure of debtor-in-possession to make payments primary reason for permitting landlords to terminate leases).

58. C.I. Mortgage Group v. Groundhog Mt. Corp. (*In re* Groundhog Mt. Corp.), 1 BANKR. CT. DEC. (CRR) 923 (S.D.N.Y. 1975).

59. Metropolitan Sav. Ass'n v. Johnson (*In re* Royal Scot, Ltd.), 2 BANKR. CT. DEC. (CRR) 374 (W.D. Mich. 1976).

60. C.I. Mortgage Group v. Groundhog Mt. Corp. (*In re* Groundhog Mt. Corp.), 1 BANKR. CT. DEC. (CRR) 923, 926 (S.D.N.Y. 1975).

61. *In re* Alex Reynolds, 1 BANKR. CT. DEC. (CRR) 210 (D. Ga. 1974).

62. *In re* Atchafalaya Workover Contractors, Inc., 1 BANKR. CT. DEC. (CRR) 499 (W.D. La. 1975).

63. Metropolitan Sav. Ass'n v. Johnson (*In re* Royal Scot, Ltd.), 2 BANKR. CT. DEC. (CRR) 374 (W.D. Mich. 1976).

immediate relief from the stay if the facts were to change,[64] and still another court conditioned the stay by providing that it should continue for a short time only.[65] Therefore, should the mortgagee's attorney fail to secure relief from the stay, he should at least be able to secure adequate safeguards for his client during its continuance.[66]

II. THE MORTGAGEE IN POSSESSION

One of the most interesting developments in bankruptcy law concerns the effect of a chapter XI proceeding upon a mortgagee who has obtained possession of, but not title to, the mortgaged premises prior to the filing of the chapter XI case. In Ohio the mortgagee can obtain possession of the mortgaged premises by the consent of the mortgagor,[67] or by filing a foreclosure proceeding and securing a receiver to collect rents and profits pursuant to the normal assignment of rents provision of the mortgage deed or under a separate assignment of rents instrument.[68] Since the typical, financially troubled mortgagor needs the rental income from the mortgaged premises, a mortgagee can seldom secure the mortgagor's consent to become a mortgagee in possession. Therefore, the most common method of obtaining possession is by filing a foreclosure proceeding and securing the appointment of a receiver ancillary to such a proceeding.[69]

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64. *In re* Alex Reynolds, 1 BANKR. CT. DEC. (CRR) 210 (D. Ga. 1974).

65. *In re* Metro Meat Packing, 1 BANKR. CT. DEC. (CRR) 229 (D. Minn. 1974).

66. The consequences of violating a rule 11-44 stay are illustrated by *In re* Fidelity Mortgage Investors, 2 BANKR. CT. DEC. (CRR) 1366 (2d Cir. 1976), in which a group of mechanic's lien claimants filed an action in federal district court in Mississippi to assure the priority of their liens two months after the debtor filed its chapter XI petition in New York. The court affirmed a contempt citation against both the lienholders and their attorneys.

67. Hyde Park Sav. & Loan Co. v. Cowles, 111 Ohio App. 343, 168 N.E.2d 602 (Hamilton County 1960).

68. Fidelity Mortgage Co. v. Mahon, 31 Ohio App. 151, 166 N.E. 207 (Cuyahoga County 1929).

69. The Ohio statutes governing the appointment and powers of a receiver are contained in chapter 2735 of the Ohio Revised Code. Section 2735.01 establishes six types of cases in which a receiver can be appointed, including

> an action by a mortgagee, for the foreclosure of his mortgage and sale of the mortgaged property, when it appears that the mortgaged property is in danger of being lost, removed, or materially injured, or that the condition of the mortgage has not been performed, and the property is probably insufficient to discharge the mortgage debt.

OHIO REV. CODE ANN. § 2735.01(B) (Page 1953). Under this provision it is not enough for the mortgagee to establish that the conditions of the mortgage have been broken and that he is entitled to foreclose; the mortgagee must also show that the mortgaged premises are "probably insufficient to discharge the mortgage debt." Madigan v. Dollar Bldg. & Loan Co., 49 Ohio App. 69, 73-74, 195 N.E. 250, 252-53 (Franklin County 1933). However, subdivision (F) of section 2735.01 also authorizes the appointment of a receiver "[i]n all other cases in which receivers have been appointed by the usages of equity." It has been held that a mortgagee can also secure the appointment of a receiver pursuant to that subdivision without the necessity of establishing the criteria of section 2735.01(B), especially where the mortgage specifically authorizes the appointment of a receiver upon foreclosure. Federal Land Bank v. DeRan, 74 Ohio App. 365, 59 N.E.2d 54 (Sandusky County 1944). *See also* Hutchinson v. Straub, 64

There are two separate and distinct problems presented by a chapter XI case that follows a pending foreclosure of the debtor's real property in which the mortgagee has obtained possession of the premises through the appointment of a receiver. First, can the chapter XI court oust the receiver and the mortgagee from possession and permit the debtor-in-possession or the chapter XI receiver to collect the rents? Second, does either section 314 or rule 11-44 stay the continuance of the foreclosure proceeding?

It should initially be noted that a chapter XI case differs from a chapter X or chapter XII case in its effect upon pending foreclosures. Chapter X and chapter XII both contain specific provisions that allow the filing of a petition when a foreclosure receivership proceeding is pending,[70] and provide that a chapter X or chapter XII trustee or the debtor-in-possession (in a chapter XII proceeding) are vested with the rights of the foreclosure receiver and have the right to immediate possession of the property.[71] It is, therefore, clear that a chapter X or XII court can oust a foreclosure receiver or a mortgagee in possession and permit the trustee or debtor-in-possession to collect the rents and profits.[72] It is also clear that the automatic stay provisions

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Ohio St. 413, 60 N.E. 602 (1901). Most modern mortgages contain specific provisions allowing the mortgagee to secure the appointment of a receiver upon the filing of a foreclosure, and it has been the authors' experience that the trial courts in Ohio will generally appoint a receiver based upon such contractual provisions without the necessity of establishing the criteria of section 2735.01(B).

70. With respect to chapter X, section 256 provides:

> A petition may be filed under this chapter notwithstanding the pendency of a prior mortgage foreclosure, equity, or other proceeding in a court of the United States or of any State in which a receiver or trustee of all or any part of the property of a debtor has been appointed or for whose appointment an application has been made.

11 U.S.C. § 656 (1970).

Chapter XII contains an identical provision in section 506, 11 U.S.C. § 906 (1970). Although chapter XI does not contain a similar provision, it is clear from the cases discussed in this article that a chapter XI petition can also be filed even if a foreclosure receivership proceeding is pending.

71. With respect to chapter X, section 257 provides:

> The trustee appointed under this chapter, upon his qualification, or if a debtor is continued in possession, the debtor, shall become vested with the rights, if any, of such prior receiver or trustee in such property and with the right to the immediate possession thereof. The trustee or debtor in possession shall also have the right to immediate possession of all property of the debtor in the possession of a trustee under a trust deed or a mortgagee under a mortgage.

11 U.S.C. § 657 (1970).

Section 507 contains similar provisions with respect to a chapter XII case. 11 U.S.C. § 907 (1970).

72. In the recent case of Charlestown Sav. Bank v. Martin (*In re* Colonial Realty Inv. Co.), 516 F.2d 154 (1st Cir. 1975), a mortgagee had obtained possession of certain apartment complexes owned by the debtors or entities related to the debtors prior to the filing of the chapter XII case. The debtors applied to the court for an order that the mortgagee be required to turn over possession of the properties to the debtors. In affirming the order that the properties be turned over to the debtors the First Circuit relied upon the explicit language of section 507, and held that said section "must be read to mean what it says, for it is an integral part of the machinery constructed by Congress in Chapter XII." *Id.* at 158. In reaching its decision the court analogized a chapter XII proceeding to a chapter X proceeding and saw no reason to distinguish between the two as far as the turnover order was concerned. It noted that the

of chapters X and XII stay the continuance of the foreclosure proceeding.[73]

Chapter XI does not contain similar provisions. However, section 311 gives the chapter XI court "exclusive jurisdiction of the debtor and his property, wherever located."[74] Does this broad grant of jurisdiction give the chapter XI court the power to oust a previously appointed state court foreclosure receiver from possession? Or is the chapter XI court's jurisdiction over a state court foreclosure receiver limited by section 2a(21) of the straight bankruptcy provisions, which grants jurisdiction to the bankruptcy court to:

> Require receivers or trustees appointed in proceedings not under this title, assignees for the benefit of creditors, and agents authorized to take possession of or to liquidate a person's property to deliver the property in their possession or under their control to the receiver or trustee appointed under this title or, where an arrangement or a plan under this title has been confirmed and such property has not prior thereto been delivered to a receiver or trustee appointed under this title, to deliver such property to the debtor or other person entitled to such property according to the provisions of the arrangement or plan, and in all such cases to account to the court for the disposition by them of the property of such bankrupt or debtor: *provided, however,* That such delivery and accounting shall not be required, except in proceedings under section 205 and chapters 10 and 12 of this title, if the receiver or trustee was appointed, the assignment was made, or the agent was authorized more than four months prior to the date of bankruptcy.[75]

If section 2a(21) applies to chapter XI, it would appear that a chapter XI court cannot oust the receiver from possession and place collection of the rents and profits in the debtor when the receiver was appointed more than four months before the chapter XI filing. Section 302 provides that the provisions of chapters I to VII of the Bankruptcy Act shall apply to chapter XI proceedings unless they are "in-

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courts in chapter X proceedings have consistently conferred summary jurisdiction in the chapter X court over property in the possession of a mortgagee. *See* Reconstruction Fin. Corp. v. Kaplan (*In re* Waltham Watch Co.), 185 F.2d 791 (1st Cir. 1950); Crystal v. Green Point Sav. Bank (*In re* Franklin Garden Apts.), 124 F.2d 451 (2d Cir. 1941). *See also In re* Riker Delaware Corp., 385 F.2d 124 (3d Cir. 1967). The same result would follow if a receiver had been appointed at the request of a mortgagee. *See* Charlton v. Munyan (*In re* Shelburne, Inc.), 102 F.2d 612 (3d Cir. 1939).

73. This was true even before the new Bankruptcy Rules were adopted. In Mongiello Bros. Coal Corp. v. Houghtaling Properties, Inc., 309 F.2d 925 (5th Cir. 1962), a mortgage foreclosure was filed before the chapter X petition and the lower court stayed the foreclosure upon the approval of the chapter X petition. The mortgagee contended that since the mortgage lien attached more than four months prior to the chapter X filing, the foreclosure should not be stayed. The Fifth Circuit rejected this position, thinking it clear that mortgage foreclosure proceedings are automatically stayed upon the approval of the petition for reorganization. For a general discussion of the impact of the automatic stay provisions of chapters X and XII on previously filed foreclosure proceedings, see Countryman, *Real Estate Liens in Business Rehabilitation Cases*, 50 AM. BANKR. L.J. 303 (1976).

74. 11 U.S.C. § 711 (1970).

75. 11 U.S.C. § 11(a)(21) (1970).

consistent with or in conflict with"[76] the chapter XI provisions. The courts that have considered whether section 311's grant of exclusive jurisdiction over the debtor's property is inconsistent with section 2a(21) have held that these provisions are not inconsistent, and that a chapter XI court cannot oust the state court foreclosure receiver from possession if he was appointed more than four months before the chapter XI filing.

In *Atlanta Flooring & Insulation Co. v. Oberdorfer Insurance Agency*[77] a judgment lien creditor filed a state court action to enforce its lien, and secured a receiver of the debtor's assets. More than four months after the appointment of the receiver, the debtor was adjudicated a bankrupt on an involuntary petition. The bankruptcy receiver applied to the state court for a turnover order with respect to the debtor's property that was in the possession of the state court receiver, and upon the state court's refusal to issue it the bankruptcy receiver applied to the bankruptcy court for the order. The bankruptcy referee refused to grant the order on the ground that section 2a(21) precluded a turnover order in a straight bankruptcy if the state court receiver was appointed more than four months prior to the filing of the bankruptcy. The Fifth Circuit Court of Appeals affirmed. Thereafter, the bankrupt filed a chapter XI petition, and the issue of whether the chapter XI court had any greater power to oust the receiver from possession than did the bankruptcy court in a straight bankruptcy was presented to the Fifth Circuit in the companion case of *Yoshinuma v. Oberdorfer Insurance Agency.*[78] The debtor argued that since section 311 gave the chapter XI court exclusive jurisdiction of the debtor's property, the court had the power to order a turnover of the property in the hands of the state court receiver. Rejecting the debtor's contention, the Fifth Circuit held:

> It is settled law that where, as here, the state court took jurisdiction to foreclose a lien and appointed a receiver more than four months before the commencement of proceedings in bankruptcy, the power of the bankruptcy court in proceedings under chapter XI is not greater than that of the court in ordinary bankruptcy proceedings. The filing by the bankrupt of his arrangement petition had no more effect to oust the jurisdiction of the State Court than the filing by his creditors of an involuntary petition in bankruptcy had.[79]

The Fourth Circuit followed the reasoning of *Yoshinuma* in *Stevens v. Carolina Scenic Stages,*[80] which involved a general state court receiver that had been appointed approximately twenty-one

76. 11 U.S.C. § 702 (1970).

77. 136 F.2d 457 (5th Cir. 1943).

78. 136 F.2d 460 (5th Cir.), *cert. denied,* 320 U.S. 785 (1943).

79. *Id.* at 461.

80. 208 F.2d 332 (4th Cir. 1953), *cert. denied,* 347 U.S. 917 (1954).

months prior to the filing of the chapter XI petition. The court found that Congress had made manifest its intention that a chapter X or chapter XII court be empowered to oust a state court receiver from possession regardless of when the receiver was appointed, but, without commenting on section 311, found no such manifestation of intent with respect to chapter XI. The court suggested that the debtor file a chapter X case if it wanted to oust the receiver from possession.[81] Without citing *Yoshinuma* the Third Circuit Court of Appeals reached the same conclusion in *In re Distillers Factors Corp.*[82] In that case the state court had ordered a dissolution of the debtor and appointed a receiver to liquidate the debtor's assets. Two years after the receiver was appointed, the debtor filed a chapter XI petition. In refusing to disturb the possession of the state court receiver, the Third Circuit held that the power of a chapter XI court is entirely dependent on section 2a(21) of the Bankruptcy Act.[83] The court did not discuss the effect of section 311.

Although the foregoing cases did not involve the appointment of a receiver ancillary to a mortgage foreclosure proceeding, it is clear that the result would have been the same, as the Sixth Circuit held in *Akron National Bank & Trust Co. v. Freed & Co.*[84] Notably, most of the cases that have applied section 2a(21) in chapter XI cases have not been troubled by the broad jurisdictional grant of exclusive jurisdiction over all of the debtor's property contained in section 311.[85]

One could logically argue that when Congress granted the chapter XI court "exclusive jurisdiction of the debtor and his property, wherever located" it did so to the exclusion of a state court that had previously appointed a receiver to take possession of the debtor's property. Congress did not limit the exclusive jurisdiction of the chapter XI court to property in the debtor's possession.[86] By making section 2a(21) applicable to chapter XI cases the courts have, at least arguably, rewritten section 311 to provide that the chapter XI court has exclusive jurisdiction over the debtor's property wherever located, unless the property has been in the possession of a state court receiver for more than four months prior to the filing of the chapter XI petition. Would it not have been more consistent with the rehabilitative purpose of chapter XI and the clear language of section 311 to conclude

81. *Id.* at 335-36.

82. 187 F.2d 685 (3rd Cir. 1951).

83. *Id.* at 687.

84. 534 F.2d 1235 (6th Cir. 1976).

85. Most of the cases do not even discuss section 311. A notable exception is *Yoshinuma*, in which the debtor made a section 311 argument. 136 F.2d at 461.

86. It has long been the case in a straight bankruptcy proceeding that the court has jurisdiction over only that property of the bankrupt which is in his possession at the time of bankruptcy. Thompson v. Magnolia Petroleum Co., 309 U.S. 478, 481 (1940). However, the straight bankruptcy provisions do not contain a provision similar to section 311.

that section 2a(21) and section 311 are inconsistent, and that section 311 controls by virtue of section 302?

A particularly nonpersuasive reason for applying section 2a(21) to a chapter XI case but not to a chapter X or XII case is that the chapter X and XII cases require possession of the debtor's property in the trustee or the debtor-in-possession (chapter XII) in order to effectuate a reorganization or rehabilitation of the debtor.[87] In most chapter XI cases the debtor's ability to control his property is just as crucial to the success of his plan of arrangement and rehabilitation as in a chapter X or XII case. The primary purpose of all three chapters is the rehabilitation of the debtor, and this purpose can best be accomplished if the chapter court has control of all of the debtor's property.

Perhaps the most persuasive argument in support of the application of section 2a(21) to a chapter XI case but not to chapter X or XII cases is the exclusion by Congress from chapter XI of the specific provisions contained in chapters X and XII providing that the trustee or debtor-in-possession shall be entitled to immediate possession of the debtor's property in the hands of the receiver. Both chapters X and XII contain, in sections 111 and 411 respectively, provisions identical to section 311 of chapter XI. Therefore, if Congress had intended sections 111, 311, and 411 to give the chapter XI court control of the debtor's property in the hands of a state court receiver, it would have been unnecessary to include specific provisions to that effect in chapter X and XII. By excluding a specific provision from chapter XI the courts have concluded that Congress intended a chapter XI court to be bound by the general bankruptcy provision of section 2a(21). In addition, section 2a(21) expressly excludes chapter X and XII proceedings from the proviso that receivers do not have to account and deliver possession to the bankruptcy trustee if appointed more than four months prior to the date of bankruptcy.

Even if one concedes that Congress did intend chapter X and XII courts to have greater control over the property of the debtor in the hands of a state court receiver, Congress must have also intended a chapter XI court to have more control over such property than a straight bankruptcy court, since the broad jurisdictional grant of section 311 does not have a counterpart in the straight bankruptcy provisions. A recent Sixth Circuit case has adopted an approach that is, in effect, a compromise between the total control provisions of chapters X and XII and the very minimal control provisions of the straight bankruptcy chapters. In *Akron National Bank & Trust Co. v. Freed & Co.*[88] the Bank held a mortgage on certain real estate owned by

87. Stevens v. Carolina Scenic Stages, 208 F.2d 332, 335 (4th Cir. 1953), *cert. denied*, 347 U.S. 917 (1954), suggests this reason.

88. 534 F.2d 1235 (6th Cir. 1976).

the debtor, and filed a foreclosure action in state court in July 1973 to foreclose the mortgage. Ancillary to the foreclosure action the court appointed a receiver to manage the estate. On November 13, 1974, the date of trial of the foreclosure action, the debtor filed a petition for an arrangement under chapter XI in United States District Court. Upon notice of the chapter XI filing the state court suspended the trial proceedings. Within a few days thereafter the Bank filed a complaint in the chapter XI court under rule 11-44(d) seeking relief from the rule 11-44 stay order of the foreclosure proceeding. The theory of the Bank's complaint was that, under cases such as *Yoshinuma*, the chapter XI court had no jurisdiction to take possession of the real estate from the state court receiver who had been in possession for more than four months. Therefore, the Bank contended, the chapter XI court had no more jurisdiction than a court in a straight bankruptcy, and lacked jurisdiction over the previously commenced foreclosure proceeding. The bankruptcy judge concluded that there was substantial equity in the property, and that under normal rule 11-44 principles the debtor would be entitled to a continuation of the stay. The judge held, however, that he did lack jurisdiction to continue the stay since possession of the property by the state court receiver divested the debtor of the real estate, so that it was no longer "property of the debtor" subject to the stay provisions of chapter XI.

On appeal the district court reversed, holding that the Bankruptcy Court had jurisdiction to continue the rule 11-44 stay. The Sixth Circuit Court of Appeals, in affirming the district court, agreed with the Fifth Circuit in *Yoshinuma* that a chapter XI court lacks power to take possession from a foreclosure receiver appointed more than four months prior to a chapter XI filing. In agreeing with *Yoshinuma*, the Sixth Circuit attributed to the Fifth Circuit a holding that section 311 did not enlarge the power of a chapter XI court beyond the powers of a straight bankruptcy court. However, the court distinguished between the power of a chapter XI court to oust a foreclosure receiver from possession and the power to enjoin the foreclosure proceeding. It rejected the Bank's argument that since the chapter XI court could not control possession of the mortgaged premises it could not stay the foreclosure proceeding, noting that to hold that a chapter XI court has no more power than a straight bankruptcy court to stay a foreclosure proceeding was to ignore the plain language of section 314, which specifically grants stay powers to a chapter XI court "in addition to" the powers granted to a straight bankruptcy court. The court also recognized that a chapter XI court "has no power to affect the claim of a secured creditor, yet it has power to enjoin enforcement of such claim."[89]

89. *Id.* at 1238.

The Bank also contended that section 314 was inapplicable because it refers to stays against the continuation of a suit to enforce a lien "upon the *property* of the debtor," and to be "property" of the debtor it must be in his possession. In rejecting the Bank's argument, the court did not merely state that the debtor's title to the property was sufficient to make it his property, as it might have done, but embarked upon an analysis of whether the property had equity. It concluded that the property did have equity above the loan balance, and that the chapter XI court had jurisdiction over this excess value.[90] Does this imply the converse, that if property has no equity it is not "property of the debtor" within the meaning of section 314 and rule 11-44? Absent possession by a receiver the issue of whether there is equity in the mortgaged premises does not affect the fact that it is property of the debtor, but is relevant to whether the automatic stay order of rule 11-44 should be continued or vacated. The Sixth Circuit apparently intended the same result in *Freed*, since it found that if the mortgaged premises had no equity[91] it would be an abuse of discretion to continue the stay. The correct interpretation of the Sixth Circuit's holding is: that the mortgaged real estate was the property of the debtor within the meaning of section 314 and rule 11-44 even though it was in the possession of a receiver; that section 314 and rule 11-44 grant jurisdiction to the chapter XI court to stay further proceedings in the foreclosure action involving the mortgaged real estate; and that if, as a result of a lack of equity in the mortgaged real estate, the stay would not assist in protecting the debtor's estate, it would be an abuse of discretion to continue the stay.

Although not specifically addressed by the Sixth Circuit, it follows from *Freed* that real property owned by the debtor and in possession

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90. *Id.* at 1239.

91. The court actually used the phrase "equity of redemption," which in Ohio refers to the right of the debtor to redeem the mortgaged premises from a foreclosure proceeding prior to confirmation by paying the mortgage loan balance and costs to the mortgagee. OHIO REV. CODE ANN. § 2329.33 (Page 1953). The relevant paragraph of the court's opinion states:

> If the encumbered property had no equity of redemption or if enjoining execution of the lien would not assist in protecting the debtor's estate, it would be an abuse of discretion for the Bankruptcy Court to continue to stay. That case is not now before us. Here the Bankruptcy Court may protect an equity value in excess of $500,000. This value belongs to the debtor and is properly under the jurisdiction of the Bankruptcy Court, which can enjoin foreclosure to protect that value. It is for this reason that Congress has given the Bankruptcy Court power to enjoin a foreclosure, regardless of the stage of the state court proceedings. As Collier points out:
>
> > Regardless of who has custody of the debtor's property, the secured creditor is required to first procure permission of the court to foreclose on his collateral. (8 COLLIER ON BANKRUPTCY ¶ 3.22, p. 261).

534 F.2d at 1239.

It appears that the court has used "equity of redemption" and "equity value" interchangeably, but intends the meaning of both to be "equity value." The basic principle set forth by *Collier* is obviously what the court meant to hold, *i.e.*, no matter who has possession of the debtor's property, the automatic stay of rule 11-44 is effective, and this stay is not inconsistent with the jurisdiction granted to the bankruptcy court by virtue of section 314.

of a state court foreclosure receiver is property of the debtor within the meaning of section 314 and rule 11-44, since if it were not property of the debtor those provisions would not apply and the stay would be improper. If this is property of the debtor within the meaning of section 314, why isn't it also property of the debtor within the meaning of section 311, giving the chapter XI court exclusive jurisdiction over the property? The Sixth Circuit rejected this theory and followed the Third, Fourth, and Fifth Circuits in finding that a chapter XI court cannot oust a receiver who has been in possession for more than four months. Thus, the court's compromise between the total control provisions of chapters X and XII and the minimal control provisions of straight bankruptcy consisted in recognizing that although a chapter XI court cannot oust the receiver, it can stay the foreclosure proceeding while the debtor attempts an arrangement with his unsecured creditors.[92]

The impact of chapter XI when the receiver has been appointed within four months prior to the chapter XI filing presents one final problem. Since section 2a(21) provides that a receiver need not deliver possession of the property if he was appointed more than four months prior to bankruptcy, initially it appears that the section was intended to require delivery when the receiver was appointed within the four-month period. Not so, said the Ninth Circuit in *Smith v. Hill.*[93] Following a long line of straight bankruptcy cases to the same effect,[94] the Ninth Circuit held that if the lien arising from the foreclosure for which the receiver had been appointed antedated the chapter XI filing by at least four months, and if the validity of the lien is not otherwise challenged, the receiver appointed within the four-month period cannot be removed from possession. In other words, when the appointment of a receiver is ancillary to the foreclosure of a lien, the relevant inquiry is not when the receiver was appointed but when the lien was perfected. If a valid lien was perfected more than four months before the chapter XI filing, a receiver appointed ancillary to the foreclosure of the lien cannot be ousted from possession even if he was appointed within the four-month period. The obvious corollary of *Smith* is that if the receiver appointed within the

92. The Ninth Circuit also has recognized the distinction between a chapter XI court's ability to restrain a lien proceeding under section 314 and its inability to oust a receiver under section 2a(21). Silver Gate Sav. and Loan Ass'n v. Carlson (*In re* Victor Builders, Inc.), 418 F.2d 880 (9th Cir. 1969). For a lower court decision granting a stay of a foreclosure proceeding even though a state court foreclosure receiver had possession, see *In re* Kirk Gillett, 256 F. Supp. 1016 (S.D. Cal. 1966).

93. 317 F.2d 539 (9th Cir. 1963).

94. Emil v. Hanley, 318 U.S. 515 (1943); Straton v. New, 283 U.S. 318 (1931); Murphy v. Bankers Commercial Corp., 203 F.2d 645 (2d Cir. 1953); Ross v. Carey (*In re* Broome), 174 F.2d 872 (5th Cir. 1949); Town of Agowam v. Connors, 159 F.2d 360 (1st Cir.), *cert. denied*, 330 U.S. 845 (1947); Busch v. McKey (*In re* Hillmert), 71 F.2d 411 (7th Cir. 1934); Simons v. Wells (*In re* Maier Brewing Co.), 65 F.2d 673 (9th Cir. 1933).

four-month period was not appointed ancillary to a lien foreclosure but was a general dissolution or liquidation receiver, he could be ousted from possession because there would be no lien antedating the four-month period on which to base the receiver's appointment.

Although *Smith* appears to be the only federal court of appeals decision addressing the issue of the impact of a chapter XI case on a lien-foreclosure receiver appointed within four months of the chapter XI filing, a district court has reached the same conclusion,[95] and the decision is consistent with holdings in other circuits that section 2a(21) applies in chapter XI proceedings. If section 2a(21) does apply in chapter XI proceedings, the holding of *Smith* is consistent with the straight bankruptcy cases holding that section 2a(21) will not operate to oust a receiver from possession where the receiver was appointed by a state court within four months of bankruptcy incident to the enforcement of a valid mortgage lien that predates the four-month period.[96]

Because of the possible impact of a chapter XI filing upon a previously appointed state court foreclosure receiver, attorneys for mortgagees can perform an important service for their clients by filing

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95. In *In re* Econo-Richmond, Inc., 2 BANKR. CT. DEC. (CRR) 935 (E.D. Va. 1976), the mortgagee took possession of a motel property of the debtor nine days prior to the debtor's filing of a chapter XI petition. The bankruptcy judge noted that unlike chapter X, a chapter XI proceeding does not affect secured creditors. He also noted that section 257 of chapter X grants to the trustee the immediate right of possession of the debtor's property that is held by a mortgagee, while chapter XI contains no such provision. The court concluded:

> It would thus appear there was no legislative intent to provide such relief in Chapter XI where the secured creditor has taken possession under a deed of trust or mortgage which particularly relates to real estate. . . .
>
> Counsel for the debtor in possession has contended that Section 2a(15) of Bankruptcy Act, grants this Court the inherent equity power to deprive the creditor of possession of the property. This Court is of the opinion that because the creditor . . . was in possession of the property at the time of the filing of the Chapter XI proceeding, said property is not subject to any inherent power of this Court, particularly in light of the absence of any specific section granting the Court the authority to remove the creditor from possession of the property and place therein the debtor in this proceeding.

Id. at 935-36.

The court went on to hold that it did have the power to stay any foreclosure proceeding relating to the property and to require the creditor to account for all money coming into its hands in the operation of the motel. The bankruptcy court ordered the creditor to file a full accounting with the court for all receipts and disbursements, and limited the disbursements to only the operational and maintenance costs of the motel. It specifically ordered that the creditor not pay itself any debt service or pay any other creditor secured by the property. It is interesting to note that the court did not require delivery of the property but did require an accounting in view of the fact that section 2a(21) treats delivery and accounting in the same manner.

96. *See* note 94 *supra*. Even before the adoption of section 2a(21) as part of the Chandler Act of 1938, the Supreme Court had held in Straton v. New, 283 U.S. 318 (1931), that where a lien was perfected more than four months prior to the filing of the bankruptcy, the bankruptcy court is without jurisdiction to stay the creditor's foreclosure proceeding instituted prior to the bankruptcy. Although that case involved a foreclosure proceeding commenced outside of the four-month period, the Court did not distinguish between such a proceeding and one commenced within the four-month period where the lien was perfected for more than four months as of the date of bankruptcy.

for foreclosure as soon as possible after default, and by getting a receiver appointed to collect the rents and profits. If a chapter XI case ensues, rule 11-44 will stay the foreclosure proceeding, but the receiver can continue in possession to collect the rents and profits and to preserve the property for the benefit of the mortgagee. Many state courts permit the mortgagee to select or suggest a receiver, and in view of the possible length of chapter XI cases it is to the mortgagee's advantage to have someone other than the debtor in control. A matter of a few days can be important, as illustrated by a recent case in which the obtaining of possession by a mortgagee nine days before the chapter XI filing was sufficient to oust the debtor from possession and to retain possession by the mortgagee during the chapter XI case.[97] Obviously, possession by the mortgagee or its receiver during the pendency of the chapter XI case, with the ability to collect the rents and profits means a much more agreeable situation for the mortgagee if it can't get immediate relief from the rule 11-44 stay. At the same time the mortgagee's attorney can pursue a vacation of the rule 11-44 stay knowing that his client will have the benefit of the rents and can assure preservation of the premises.

III. THE IMPACT OF THE RULE 11-44 STAY ON THE FLOATING LIEN CREDITOR AND THE DEBTOR'S USE OF COLLATERAL

When the debtor is a manufacturer or retailer[98] and the secured creditor has a perfected security interest in accounts receivable and inventory,[99] the legal impact of a chapter XI filing is not substantially different from its impact on the real estate mortgagee—the creditor is automatically enjoined under rule 11-44 from employing legal process or taking any action to enforce his lien.[100] The practical impact on the floating lien creditor, however, may be substantially more harsh; for this reason, it is in cases dealing primarily with floating

97. *In re* Econo-Richmond, Inc., 2 BANKR. CT. DEC. (CRR) 935 (E.D. Va. 1976).

98. The debtor need not be a manufacturer or retailer for the following analysis to apply, but can be any kind of debtor who is likely to have given inventory and accounts receivable as security. A manufacturing or retailing situation is especially illustrative of the problem encountered, however, and for that reason is used here.

99. Security interests of this type are hereinafter referred to as "floating liens." The authorization for their use and the manner in which they attach to the inventory and accounts of the debtor are more fully discussed below. Secured creditors holding this type of collateral are hereinafter referred to as "floating lien creditors."

100. This broad injunctive language means that the floating lien creditor is enjoined from proceeding in accordance with his rights of repossession, collection, or disposition of collateral pursuant to U.C.C. §§ 9-501 to 9-507 (1972 version) at whatever point he has reached. That is, if he has repossessed, he cannot sell and so forth. There is, however, an unresolved question relating to the collection of accounts receivable. U.C.C. § 9-502 (1972 version) states that accounts receivable collateral may be collected by giving notice to the account debtor to pay the secured creditor directly. If the imposition of the rule 11-44 stay occurs after this notice is given, the receipt of payment by the secured creditor does not appear to be an "act" so as to violate the stay provisions of the rule. Application of collected amounts, however, may be such an act and would therefore appear to violate the rule.

lien collateral that the battles over the use of collateral have largely been fought.[101]

For a manufacturer or retailer seeking to make an arrangement with his unsecured creditors it is imperative to the chapter XI plan that the accounts receivable be used as working capital for the purchase of new inventory and for payment of other operating costs, and that inventory be sold in the normal course of business for the generation of new accounts receivable.[102] To facilitate this obvious need, in granting the debtor authority to continue the operation of its business[103] a chapter XI court will routinely grant a debtor-in-possession specific authority to retain and use the collateral that is subject to the floating lien. Illustrative of the authority commonly given to a debtor-in-possession upon the filing of a chapter XI petition is that embodied in the order entered by Bankruptcy Judge Galgay in *In re W. T. Grant Co.*,[104] authorizing the debtor-in-possession to operate its business and manage its property. That order stated in relevant part:

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101. It is more precise to state that the battles are presently being fought with respect to the use of collateral. The two principal cases dealing with the use of floating lien collateral, Chemical Bank v. American Kitchen Foods, Inc. (*In re* American Kitchen Foods, Inc.), 2 BANKR. CT. DEC. (CRR) 715 (D. Me. 1976) and Citicorp Bus. Credit, Inc. v. Blazon Flexible Flyer, Inc. (*In re* Blazon Flexible Flyer, Inc.), 407 F. Supp. 861 (N.D. Ohio 1976), are both very recent cases. *Blazon* is presently on appeal to the Sixth Circuit, and in *American Kitchen Foods*, parts of the operating orders have been appealed to the district court. With respect to the continuing fight over use of collateral, Bankruptcy Judge Cyr stated in *American Kitchen Foods*:

> The power of the bankruptcy court to authorize retention and use of collateral and proceeds to fund continuing Chapter XI business operations is under direct challenge. Although the retention and use of collateral in Chapter XI proceedings can no longer be considered a frontier, it is yet to be extensively charted. Notwithstanding the fact that Chapter XI debtors retain and use collateral and proceeds routinely, almost as a matter of right incident to the pendency of the automatic stay imposed against lien enforcement by Chapter XI Rule 11-44, there is almost no reported case law on the subject.

2 BANKR. CT. DEC. (CRR) at 717.

102. With respect to this need, Judge Cyr stated in *American Kitchen Foods*:

> Were it not for the interposition of legal constraints upon lien enforcement the ubiquitous floating lien could conceivably preempt virtually every attempt at arrangement proceedings. Continued business operations would be rendered impracticable, just as in the instant case, due to dispossessions of indispensable collateral, leaving no alternative but liquidation with its attendant waste and disruption.

Id. at 718. The second criterion described in Nat'l Life Ins. Co. v. Jenifer Mall Corp. (*In re* Jenifer Mall Corp.), 1 BANKR. CT. DEC. (CRR) 179 (D.D.C. 1974), *see* text accompanying note 24 *supra*, is largely presumed in these cases.

103. Bankruptcy Act § 342 states: "Where no receiver or trustee is appointed, the debtor shall continue in possession of his property and shall have all the title and exercise all the powers of a trustee appointed under this title. . . ." 11 U.S.C. § 742 (1970). Section 343 states that: "[T]he debtor in possession . . . shall have the power, upon authorization by and subject to the control of the court, to operate the business and manage the property of the debtor. . . ." 11 U.S.C. § 743 (1970). These provisions are supplemented by chapter XI, rule 11-18. In most cases, when the continued operation of the business is critical to the success of the arrangement, an ex parte order granting the debtor-in-possession the right to continue in possession of the property and operate the business, entered pursuant to rule 11-18 and the above cited sections, is entered by the court on the same day that the chapter XI petition is filed.

104. *In re* W.T. Grant Co., No. 75-B-1735, (S.D.N.Y., Oct. 2, 1975) (granting operating order). This order was entered October 2, 1975. Similar authority was granted to the debtor-in-possession on the filing date in both Citicorp Bus. Credit Corp. v. Blazon Flexible Flyer, Inc.

> ORDERED that said debtor-in-possession shall close the present books of account as of the close of business on the date of entry of this order, and shall open new books of account as of the opening of business of the next succeeding business day, in which new books of account shall cause to be kept proper accounts of its earnings, expenses, receipts, disbursements and all obligations incurred and transactions had in the operation of the business, and the management, preservation and protection of the properties of the within estate;
>
> . . . .
>
> ORDERED that the debtor-in-possession be and it hereby is authorized, in the operation of its business and until further order of this court, (a) to sell inventories, merchandise and other tangible personal property of every kind and description attained by the debtor prior to the filing of the petition herein and to collect and use the proceeds thereof, in whatever form, and (b) to collect and realize upon all accounts, contract rights, chattel paper, instruments and general intangibles owned by the debtor at the time of the filing of the petition herein and to use the proceeds thereof (including any proceeds constituting collateral for any secured creditor at the time of such filing) in whatever form; . . .[105]

When the debtor-in-possession is authorized to retain and use real property collateral, the collateral remains subject to the secured creditor's mortgage, and ordinarily is not used up in the operation of the business, nor does it depreciate so quickly that drastic measures are required to protect the secured party's interest.[106] When the security consists of accounts receivable and inventory, however, unless the secured creditor obtains a specific grant of a new security interest, his floating lien is cut off by the chapter XI filing, and his collateral is subject to complete dissipation by the operation of the business by the debtor-in-possession. Unless very strict protective measures are required of the debtor-in-possession to monitor the continuing sufficiency of the floating lien collateral, the floating lien creditor may be subjected to substantial risks, and his collateral impaired.

Were the floating lien creditor without recourse, and subjected to either total dissipation of his collateral or other collateral impairment, the court would clearly be exercising an authority not granted by chapter XI, and would also be violating the constitutional prohibition against the uncompensated taking of property.[107] To facilitate

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(*In re* Blazon Flexible Flyer, Inc.), 407 F. Supp. 861 (N.D. Ohio 1976) and Chemical Bank v. American Kitchen Foods, Inc. (*In re* American Kitchen Foods, Inc.), 2 BANKR. CT. DEC. (CRR) 715 (D. Me. 1976).

105. *In re* W.T. Grant Co., No 75-B-1735, (S.D.N.Y., Oct 2, 1975) (granting operating order).

106. Equipment collateral is basically like real property collateral, in that it is not immediately used up by the debtor.

107. For discussion of the lack of authority of a chapter XI court to materially and adversely affect the rights of secured creditors, and the constitutional objection to its doing so, see note 38 *supra*. It should be noted that the battles over use of floating lien collateral are presently being waged on precisely these grounds and, as stated by Judge Cyr, the ground has yet to be "extensively charted." (*Blazon* and *American Kitchen Foods* are presently on appeal.

the purpose of chapter XI, which is to allow the debtor to effect an arrangement with his unsecured creditors, the courts have fashioned remedies and safeguards to overcome these prima facie violations of secured creditors' rights. Since the validity of these safeguards and remedies has been upheld to date, it is assumed, for purposes of this discussion, that they are proper. Even after applying these safeguards, courts must consider whether the secured creditor's rights are "materially and adversely affected." If so, relief from the rule 11-44 stay must be granted and the floating lien creditor given the right to realize on his collateral.

The balance of this discussion describes some of the initial problems faced by the floating lien creditor, together with the safeguards and remedies that have been fashioned by the courts to overcome them. Finally, the standards for determining whether, after application of the remedies and safeguards, the secured creditor is still materially and adversely affected so as to require a grant of relief from the rule 11-44 stay order will be examined.

A. *Initial Problems and Their Safeguards and Remedies*

1. *Floating Lien Cut-off.*

In the normal floating lien situation inventory is constantly sold and accounts receivable are collected. The dissipated collateral is also continually replaced by new inventory and accounts receivable, which are in turn subjected to the secured creditor's floating lien pursuant to an "after-acquired property" provision in his security agreement, as authorized by Article 9 of the Uniform Commercial Code.[108] So long as collateral is maintained at an adequate level, therefore, the secured creditor need not take further action to ensure that his loan is fully secured. Upon the filing of a chapter XI petition, however, unless a new lien is granted by the debtor-in-possession, the floating lien of the secured creditor will be cut off as to property acquired thereafter, and the floating lien creditor's security will be dissipated in the operation of the business.

See note 101 *supra*.) The assumption on which this argument proceeds, as described in the following text, is subject to confirmation or rejection by the courts. A thorough discussion of the constitutional and statutory objection is avoided here, because the purpose of this article is to describe the current state of the law rather than to argue for any particular result.

108. A standard property description will include a description of the collateral which covers accounts receivable and inventory of the debtor whenever acquired. Authorization for such a security interest in after-acquired property is found in U.C.C. § 9-204 (1962 version), which states in relevant part: "[A] security agreement may provide that collateral, whenever acquired, shall secure all obligations covered by the security agreement." After the enactment of the Uniform Commercial Code, there was some controversy regarding the validity of a security interest in after-acquired property against a bankruptcy trustee or trustee entity like a debtor-in-possession. The question has been largely resolved and the floating liens, if properly perfected, have withstood attack. An illustrative Ohio case upholding the validity of the floating lien is *In re* White, 263 F. Supp. 208 (S.D. Ohio 1967). *See also* U.C.C. § 9-108 (1972 version).

The floating lien will not apply to inventory and accounts receivable acquired by the debtor-in-possession after filing of the chapter XI petition, because the debtor-in-possession is a separate legal entity from the debtor, a distinction clearly made by the Bankruptcy Act. The debtor files the chapter XI petition,[109] proposes the arrangement,[110] and makes the deposit prior to confirmation.[111] It is the debtor-in-possession who may be authorized to operate the business[112] and to issue certificates of indebtedness.[113] In *In re Sequential Information Systems, Inc.*,[114] then bankruptcy referee Herzog held:

> It is perfectly clear, then, that the debtor-in-possession is an entity separate and distinct from the debtor who filed the Chapter XI petition and who proposes an arrangement to his creditors. The debtor-in-possession, when authorized to operate the business, is required to open a new set of books and deposit funds in a "debtor-in-possession" bank account from which withdrawals are made in the current operation of the business . . . .[115]

Because the postfiling entity is a separate legal entity from the prefiling debtor, inventory and accounts receivable acquired by the postfiling entity, the debtor-in-possession, are not subject to the security interest of the secured creditor who claims an interest in after-acquired property of the prefiling debtor.[116] The 1962 version of Uniform Commercial Code section 9-204(1) states:

> A security interest cannot attach until there is agreement (subsection (3) of Section 1-201) that it attach and value is given *and the debtor has rights in the collateral.* It attaches as soon as all of the events in the preceding sentence have taken place unless explicit agreement postpones the time of attaching.[117]

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109. Bankruptcy Act §§ 321 & 322, 11 U.S.C. §§ 721 & 722 (1970); rule 11-3.

110. Bankruptcy Act § 323, 11 U.S.C. § 723 (1970); rule 11-6.

111. Bankruptcy Act § 337, 11 U.S.C. § 737 (1970); rule 11-38(a).

112. Bankruptcy Act § 343, 11 U.S.C. § 743 (1970); rule 11-23.

113. Bankruptcy Act § 344, 11 U.S.C. § 744 (1970).

114. 4 SEC. TRANS. GUIDE (CCH) ¶ 51,479 (S.D.N.Y. 1970).

115. *Id.* at 66,433. In Shopman's Local 455 v. Kevin Steel Prods., Inc., 519 F.2d 698 (2d Cir. 1975), the Court of Appeals for the Second Circuit confirmed this finding by stating: "A debtor-in-possession under Chapter XI or under Chapter X, a trustee under the latter Chapter, or a trustee in a straight bankruptcy proceeding is not the same entity as a pre-bankruptcy company." *Id.* at 704.

116. It must be recognized that inventory and accounts receivable acquired by the debtor-in-possession after filing of a chapter XI petition may be proceeds, as that term is defined in U.C.C. § 9-306 (1972 version), and for that reason may become subject to the security interest of the creditor of the prefiling entity. Since there will necessarily be some slippage in attempts to trace proceeds of the prefiling collateral to the assets of the postfiling debtor-in-possession, and because this slippage becomes greater and greater as the inventory and accounts receivable continue to turn, the proceeds arguments is ignored for purposes of illustrating this threshold problem.

117. U.C.C. § 9-204(1) (1962 version) (emphasis added). The 1972 amendments to the Uniform Commercial Code, not yet enacted in Ohio, consolidate the provisions of former §§ 9-203 and 9-204. These consolidations make clear that the concept of attachment of a security interest is related to enforceability. The amendment shows with more clarity than exists under

Since inventory and accounts receivable obtained by the debtor-in-possession after filing are assets of that entity except to the extent that a tracing of proceeds is possible,[118] the prefiling debtor does not obtain "rights in the collateral" as required by U.C.C. section 9-204.[119] Without such debtor rights in the collateral the security interest claimed by the floating lien creditor cannot attach,[120] and without attachment cannot be perfected.

When an order is entered granting the debtor-in-possession authority to retain and use inventory and accounts of the debtor, the debtor-in-possession will, by selling inventory and using the accounts receivable of the prefiling debtor, dissipate the collateral of the secured creditor. He will replace that collateral with new inventory and accounts receivable of the debtor-in-possession, free and clear of floating lien claims. Under rule 11-44 the secured creditor is also enjoined from initiating or continuing any proceeding, or taking any other act to realize on his security. Thus, the debtor-in-possession is able to dissipate the collateral and replace it with similar property not subject to the floating lien, and the secured creditor is enjoined from pursuing his remedies to realize on the collateral while it is being dissipated.

Courts faced with this problem of violating the rights of secured creditors have solved it through the most obvious of expedients: they have simply required the debtor-in-possession to account for the use of any floating lien collateral, considered this use a cost of administration,[121] and secured that cost of administration to the secured creditor by placing a lien on all property of the debtor-in-possession.[122] In *Chemical Bank v. American Kitchen Foods, Inc.*[123] the court authorized the debtor to continue using the collateral subject to the floating lien of the secured creditor; as a condition to this authorization, however, the court required:

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the 1962 version of Article 9, that until a secured creditor's debtor acquires rights in the collateral, the security interest is not enforceable with respect to that collateral, either against the debtor or third persons.

118. *See* note 116 *supra.*

119. *See* note 117 *supra.*

120. *Id. See also* U.C.C. § 9-303 (1972 version), which shows that attachment of the security interest is a requisite of perfection; that is, a security interest cannot be perfected until it has attached.

121. Costs of administration are entitled to a first priority in payment from a chapter XI estate. *See* Bankruptcy Act § 64(a)(1), 11 U.S.C. § 104(a)(1) (1970). These costs must be paid in full before any chapter XI plan can be confirmed. *See* Bankruptcy Act § 337, 11 U.S.C. § 737 (1970), and rule 11-38.

122. There are several variants on this theme. For example, some courts have prohibited use of floating lien collateral until after it has been "purchased" from the secured creditor with borrowings from that creditor evidenced by certificates of indebtedness issued by the debtor-in-possession and secured by its assets. These borrowings are also treated as costs of administration. The effect is the same regardless of the form these remedies take.

123. 2 BANKR. CT. DEC. (CRR) 715 (D. Me. 1976).

> That to the extent use is made of such assets and proceeds, the claim of any creditor holding or entitled to the benefit of a valid security interest therein shall constitute a valid and enforceable secured claim against the assets of the debtors in possession whether now existing or hereafter acquired, and shall be entitled to priority and payment as an expense of administration, secured (subject to valid liens existing at the time of filing of the petition herein as to which the lien herein granted has not been substituted) by all property of the debtors in possession, including but not limited to inventories, merchandise, accounts, contract rights, chattel paper, instruments, securities, general intangibles, equipment and fixtures, and real property and the proceeds thereof of the debtors in possession (whether received by it from the debtors or acquired on or after the date of filing of the petitions herein).[124]

By means of such protective orders courts have overcome the initial problem of collateral dissipation. Having overcome this threshold problem, these courts have then considered whether the total amount of collateral subject to the security interest of the floating lien creditor remains sufficient during the course of a chapter XI proceeding to adequately secure his rights.[125]

While the problem of collateral dissipation should be remedied as a precondition to authorizing the debtor-in-possession to retain and use floating lien collateral, in at least two unofficially reported bankruptcy court decisions it appears that no such protective measure was taken and that the floating lien creditor suffered the kind of dissipation of collateral described above.[126] As soon as a chapter XI petition is filed, therefore, the order allowing the debtor-in-possession to operate the business and to retain and use collateral should be examined by the attorney for the secured creditor to determine the extent of the protection given for floating lien collateral. Appropriate remedial action should obviously be taken if sufficient protection is not included.[127]

2. *Other Detriments to Floating Lien Creditors.*

Even if the operating order granting the debtor-in-possession the right to retain and use floating lien collateral has granted the creditor

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124. *Id.* at 716 n. 4. *See also* Citicorp Bus. Credit, Inc. v. Blazon Flexible Flyer, Inc. (*In re* Blazon Flexible Flyer, Inc.), 407 F. Supp. 861, 863 (N.D. Ohio 1976).

125. See text accompanying notes 128-40 *infra*, for standards used to determine this question.

126. *See* Ver Halen, Inc. v. Siehr (*In re* DeGayner Homes, Inc.), 1 BANKR. CT. DEC. (CRR) 532 (W.D. Wis. 1975); *In re* Sequential Info. Systems, Inc., 4 SEC. TRANS. GUIDE (CCH) ¶ 51,479.

127. If no protective measures are included for floating lien collateral, it would seem to be an appropriate case for immediate, and, if necessary, ex parte relief from the rule 11-44 stay, as authorized by rule 11-44(e). *See* note 16 *supra*. A motion to set aside the operating order which causes the collateral dissipation may also be appropriate. This motion would be made pursuant to bankruptcy rule 914, made applicable in chapter XI proceedings by chapter XI rule 11-63.

a new lien on accounts receivable and inventory acquired after the filing of the petition, the secured creditor is subjected to several other threshold risks against which he must be protected. For example, the chapter XI debtor-in-possession may not be replacing the postfiling inventory and accounts receivable at the rate that it is depleting the prefiling collateral, thereby cutting into the secured creditor's interests. Alternatively, the debtor-in-possession may be taking advantage of the rule 11-44 stay order by not making current payments on the secured creditor's debt, causing the secured debt to increase through interest accumulation without adequate collateral protection.[128] To protect against these risks, the courts have fashioned procedures for continual monitoring of the effect of the use of collateral on the secured creditor. The most stringent monitoring requirements imposed to date are those established by Judge Cyr in *Chemical Bank v. American Kitchen Foods, Inc.*[129] After authorizing the debtor-in-possession to retain and use all floating lien collateral, he required

> that the debtors-in-possession shall report in writing to any creditor claiming a lien or other security interest in or to any inventory, accounts, contract rights, chattel paper or proceeds, as to the creation, collection and disposition of any and all inventory, on a weekly basis, and, mailed on a daily basis, with respect to accounts receivable, including credits, freights and discounts with respect thereto.[130]

In another section of his order, Judge Cyr provided

> that any creditor claiming to be the holder of a security interest affected hereby may commence proceedings in this court on notice to the debtors-in-possession or such other persons as the court may designate for the determination of the authorization herein made for the continued use of all such assets by the debtor-in-possession and for such protective provisions with respect thereto as the court may deem appropriate.[131]

Such continuous monitoring of the use of collateral of floating lien creditors allows the court to establish and apply criteria for the continuance of the chapter XI stay against floating lien creditors, and for

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128. Similar kinds of impairments may vary from case to case. No exhaustive list is attempted because the fact situations presented by each case vary, as do the possible impairments that may befall the floating lien creditor. Another example of the type of impairment that may be presented is the one claimed by the secured creditor in Citicorp Bus. Credit, Inc. v. Blazon Flexible Flyer, Inc. (*In re* Blazon Flexible Flyer, Inc.), 407 F. Supp. 861 (N.D. Ohio 1976). In *Blazon* the debtor was a manufacturer of sleds, sold seasonably in the winter, and children's outdoor gym equipment, sold primarily in the spring and summer. The secured creditor in this case claimed that its collateral was impaired both because of seasonal inventory fluctuations and because the effect of imposing and continuing the rule 11-44 stay was to change the character of its collateral from one type of inventory to another. *See* Brief for Appellant, Citicorp Bus. Credit, Inc. v. Blazon Flexible Flyer, Inc. (*In re* Blazon Flexible Flyer, Inc.) (6th Cir., filed June 3, 1976).

129. 2 BANKR. CT. DEC. (CRR) 715 (D. Me. 1976).

130. *Id.* at 716 n.4.

131. *Id.*

the determination of whether the chapter XI debtor should continue to retain and use the collateral.

B. *Relief from the Rule 11-44 Stay.*

After these initial problems have been remedied or monitored to the extent possible, the attorney for the secured creditor should ask the chapter XI court to determine whether the floating lien creditor's rights are being "materially and adversely affected" so as to require granting relief from the rule 11-44 stay. Criteria thus far established by the courts for determining this issue can be gleaned from the few cases addressing it in the context of floating lien collateral. These criteria may be stated briefly as follows: (1) Is there a reasonable possibility that a successful arrangement can be effected? (2) Is the floating lien creditor's collateral being invaded?[132]

The first of these standards, which is also one of the standards the courts employ in assessing a real property mortgagee's right to a vacation of the stay, indicates that courts must always consider the purpose of the chapter XI stay—to effect a successful arrangement—in determining whether the right of a secured creditor to realize on his collateral is outweighed by this goal. If the prospects for a successful arrangement are good, some minimal invasion of the secured creditor's rights may be allowed. Judge Cyr stated in *American Kitchen Foods*:

> Without question judicial assessment of the elusive intangibles invariably involved in projecting possible future collateral impairment risk is an inescapably rude and uncertain process. It is also undeniable that debtor rehabilitation often would be foreclosed entirely were there an absolute bar to venturing any collateral erosion whatever.[133]

Application of this standard is, therefore, no different in the floating lien situation than in the mortgage situation; it is the same standard applied by the court in *Jenifer Mall.*[134]

As to the second criterion, the valuation of floating lien collateral may be vastly different, depending on whether a "going-concern" or "forced-sale" standard is used.[135] Addressing this question directly, the court in *American Kitchen Foods* opted for a "going-concern" valuation standard. The court analogized to the standard that would

132. These criteria, here stated in more rudimentary form than in the section of this discussion relating to relief for the mortgage creditor, have a somewhat different application in the floating lien situation because the valuation problems encountered with this type of collateral are exaggerated. *See* text accompanying footnotes 135-40, *infra.*

133. 2 BANKR. CT. DEC. (CRR) 715, 720 (D. Me. 1976).

134. 1 BANKR. CT. DEC. (CRR) 179 (D.D.C. 1974).

135. This necessarily ties the first criterion to the second, since arguably a "going-concern" valuation standard would be unreasonable on its face without a determination that a successful arrangement is a reasonable probability.

be imposed on the secured creditor were he to dispose of repossessed collateral pursuant to the disposition provisions of Article 9 of the Uniform Commercial Code—commercial reasonableness.[136] Judge Cyr incorporated this standard in his determination that an "ongoing-business" valuation standard should be used:

> There can be no question but that the debtors' inventory, accounts receivable, equipment and other chattel collateral can be converted into cash in the orderly course of its business at prices ranging from 30% to 80% above forced sale recovery levels.
>
> A forced sale in these circumstances could not be considered commercially reasonable. . . .
>
> It is little more than the articulation of an unexceptionable business judgment to hold that, wherever practicable, conversion in the ordinary course of business should be considered the most commercially reasonable collateral disposition, simply because and to the extent that it is more productive. Where collateral includes inventory and receivables the distinction can be of enormous significance. While its business is operating, a Chapter XI debtor can continue to convert receivables at face value and sell inventory at market. Once business operations cease, receivables and inventory will return only a disappointing fraction of their value, particularly if they have to be liquidated in ordinary bankruptcy proceedings. It would be inept to ignore and prodigal to decline that collateral margin in the rehabilitation process.[137]

Thus, courts have used a "going-concern" basis in valuing floating lien collateral for this purpose. In the reported cases the courts have determined on this basis that the secured creditor involved was fully secured, so that no invasion of its property rights was effected by the operation of the debtor's business or the continuance of the chapter XI stay order.[138] In both *American Kitchen Foods* and *Citicorp Business Credit, Inc. v. Blazon Flexible Flyer, Inc.*[139] the courts determined that the value of the secured creditor's collateral was substantially in excess of the amount of the debt claimed.[140] As a result, the monitoring protection described above was less important than it would have been if the collateral had been valued at less than the claimed debt. When, however, a valuation of the collateral indicates that the floating lien creditor is only partially secured, the monitoring device employed by the courts should determine whether the collateral is being impaired by continued operation, requiring relief from the rule 11-44 stay.

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136. U.C.C. § 9-504 (1972 version).

137. Chemical Bank v. American Kitchen Foods, Inc. (*In re* American Kitchen Foods, Inc.), 2 BANKR. CT. DEC. (CRR) 715, 721-22 (D. Me. 1976).

138. For a discussion of the impact of this finding, see text accompanying notes 29-37 *supra.*

139. *See* note 101 *supra.*

140. The court in *Blazon* also noted that even if the valuation were halved (presumably to take into consideration forced sale losses), the secured creditor would have been fully secured.

IV. CONCLUSION

In summary, it is obvious that a chapter XI proceeding will have a significant impact upon secured creditors even though the plan of arrangement cannot modify or alter their rights. Quick and correct action by the attorney for a secured creditor in responding to or anticipating a chapter XI filing is essential to properly protect secured creditors' interests. Probably the most important function of the attorney for a mortgagee is to anticipate a chapter XI filing, and to get his foreclosure filed and receiver appointed before the chapter XI filing so that the receiver can continue in possession during the chapter XI proceeding. Thereafter, the attorney should file and pursue a complaint to vacate the rule 11-44 stay order so that his foreclosure action or other enforcement remedy may be continued or commenced.

In connection with floating liens on accounts receivable and inventory, the attorney for the secured creditor must immediately review the order granting a debtor the right to continue in possession and operate its business in order to determine whether his client's collateral is being dissipated through the continued operation of the business. If adequate safeguards have not been included, he must take immediate steps to see that they are so included. If adequate safeguards have been included, he must then look to the value of the collateral, the probability of success of a plan, and other possible detriments to his client from the continuation of the stay. Having examined all these factors, he should be in a position to ensure that the secured creditor is not "materially and adversely affected" by a chapter XI case.